Glasgow City Council

Strathclyde Pension Fund Committee

Report by Richard McIndoe, Director of Strathclyde Pension Fund

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Item 6(e)

25th November 2020

Direct Investment Portfolio (DIP)
Investment Proposal – Clydebuilt II LP

Purpose of Report:

To set out a proposal for an investment of £100m within the Direct Investment Portfolio.

Recommendations:

The Committee is asked to **APPROVE** an investment of £100m in Clydebuilt II LP by the Direct Investment Portfolio.

Ward No(s):	Citywide: ✓
Local member(s) advised: Yes ☐ No ☐	consulted: Yes ☐ No ☐

1 Background

1.1 Portfolio Establishment

In December 2009, the Strathclyde Pension Fund Committee agreed to establish a New Opportunities Portfolio (NOP) with a broad remit to invest in assets for which there was an attractive investment case but to which the current structure did not provide access.

1.2 Review

The NOP strategy was reviewed in 2012 and in 2015. It was re-branded as the Direct Investment Portfolio (DIP) in 2015. The most recent review of the DIP strategy and operating arrangements was concluded in December 2018.

1.3 Implementation Framework

DIP investment proposals are assessed on their own merits within an agreed implementation framework based on SPF's overall risk-return objectives and specific DIP parameters.

The framework agreed at the 2018 review is summarised below.

Direct Investment Portfolio	
Objectives	Primary objective identical to overall SPF investment objective. Secondary objective of adding value through investments with a positive local, economic or ESG (environmental, social, governance) impact.
Strategy & Structure	In line with SPF risk-return framework but focused on the UK and the Equity, Long Term Enhanced Yield and Short Term Enhanced Yield asset categories.
Risk and Return	Portfolio benchmark return of **CPI +3% p.a.** Individual risk and return objectives for each investment.
Capacity	Target allocation of **5%** of total Fund (based on Net Asset Values). Range of **2.5**% to **7.5%** of total Fund.
Investment Size	Target: **£20m** to **£100m** Minimum: **£10m** Maximum: greater of **£200m** or **1%** of Total Fund Value
Decision Making	3 stage process with review and satisfactory due diligence by officers, followed by a presentation to the Sounding Board before a proposal is taken to Committee for approval subject to completion of legal documentation.
Monitoring	Includes individual investment reports, participation in advisory boards, and a quarterly DIP monitoring report which is reviewed by the Fund's Investment Advisory Panel.

The following proposal has been assessed using this framework and is considered appropriate for review by the Sounding Board with a view to a recommendation being made to the Committee.

2 New Investment Proposal

2.1 Key Terms

Name	**Clydebuilt II LP**
Investment vehicle	Scottish Limited Partnership
Manager	Ediston Investment Services Limited
Sector	Property
Investment objective	to construct a mixed portfolio of income producing and development assets affording regenerative potential within the former Strathclyde regional authority area
Term	10 years (plus up to 2 year's extension)
Target size	£101m (plus debt at a maximum 35% Loan to Value)
Proposed DIP investment	£100m
Target return	10% IRR (Net)

2.2 Investment Summary

The Clydebuilt Limited Partnership ("Clydebuilt" or "Fund I") was launched by SPF in collaboration with Ediston Properties Limited ("Ediston") in 2014. The dual objectives of Fund I were to achieve a 10% net Internal Rate of Return ("IRR") by adopting an opportunistic approach to acquiring properties with income, capital growth and/or development potential, while simultaneously promoting regeneration within the former Strathclyde regional authority area.

SPF originally committed £50m to Fund I. An additional £25m was added in 2016. Ediston contributed 1% of the total on each occasion (i.e. a total of £0.75m). The Clydebuilt Fund is now a recognised, institutional, commercial property investor in the West of Scotland.

Fund I has been successful in terms of deployment of cash, construction of an attractive portfolio of 14 mixed assets, a low void rate, and a strong net yield. Sales to date have been limited but have broadly achieved the 10% net IRR target return.

A commitment by the Direct Investment Portfolio of £100m to a successor fund, Clydebuilt II LP ("Fund II") is now proposed.

More information on the investment manager is included in **Schedule 1.** A summary of the progress of Fund I is included in **Schedule 2.**

2.3 Investment Rationale

The proposed strategy for Fund II is very similar to that of Fund I, namely:

- to target non-institutional assets, being underperforming assets with significant value add potential; and
- regeneration opportunities through identifying distressed assets (properties and/or land) which require capital, in what will be a capital and debt constrained market.

As with Fund I, each asset will have a defined asset management/exit strategy adopted from the point of acquisition.

It is envisaged that where there is a strong business case, and/or a longer development period is required to optimize value, a limited number of Fund I assets may ultimately be transferred, at market value, to Fund II.

As Fund I's term has now been extended to April 2023, it is considered that the creation of a second fund with a distinct funding capacity is desirable in order to allow Fund I sufficient time to optimise the value of its portfolio of assets, while at the same time enabling SPF to take advantage of attractively priced opportunities in the current property market.

While the two funds would therefore potentially overlap by c.2 years, Fund II would be expected to be in deployment mode while Fund I is realising assets, and so broadly speaking, Fund II will effectively be replacing Fund I.

2.4 Risks

The main risks of the proposed investment in the Clydebuilt II fund are considered to be as follows:

- Market Risk
- Development/Construction Risk

A summary of risks and key mitigants is contained in **Schedule 3**.

2.5 Projected Return

The target return of Fund II's strategy is a net IRR of 10%.

KPMG reviewed Fund I during 2019. At that time a net IRR of 8.9% was recorded against a market benchmark of 8.6% for the 5 year period to June 2019, with a net yield of c.6.4% and a void rate across the portfolio of under 3% (on an income basis). KPMG considered this to be a strong performance, even if slightly below the targeted return for Fund I (a Net IRR of 10%).

2.6 Exit

Fund II will have a term of 10 years with up to an additional 2 years' extension, subject to mutual agreement. Repayment of the investment will be from the realisation of Fund II's assets by the expiry of the fund's term.

2.7 Fees

The fee structure encompasses various elements relating to the different development and operational assets of the Fund.

A Management Fee calculated on the Fund's *Net* Asset Value ("NAV") will apply both during, and following the Investment Period. A discounted fee will apply to any assets which require a defined, lower level of asset management in any calendar year, however the full fee is being budgeted for. This compares with Fund I where the fee was based on the *Gross* Asset Value ("GAV"), this being a higher figure which includes assets purchased with debt finance, although the rate was reduced following the recent extension of the fund.

The basis of calculation of the management fee (on a NAV basis) and the introduction of the discounted fee are both improvements compared with Fund I.

A one-off Development Fee will apply where Ediston acts as Project Manager in respect of development projects, and this is unchanged from Fund I. Additionally, a Performance Fee (or "Carried Interest") will apply and is structured to ensure that Ediston require to perform strongly before they benefit.

Fund I did not incorporate a performance fee structure, which is relatively unusual. Managers typically incorporate them in their pricing structure so that they share in any relative outperformance achieved. This promotes the alignment of interests of both manager and investor.

Overall the fee structure is considered acceptable.

2.8 Environmental Social and Governance Issues

Ediston Properties became a signatory to the PRI (UN Principles of Responsible Investment) in November 2019.

Ediston is committed to demonstrating the highest levels of integrity in developing and maintaining its personal and corporate reputation and to conducting its business in a competent, fair, impartial and efficient manner and aligned with the core ESG principles of the PRI.

2.9 Investment Size and Cash Requirements

SPF Fund value at 30th September 2020	£23.701bn
DIP allocation (target 5% of main fund) NAV	£ 1,185m
Current DIP NAV	£ 866m
Headroom v NAV	**£ 319m**

2.10 Investment Strategy

The proposed investment falls within the Property sector and therefore the Fund's Long Term Enhanced Yield allocation.

Allocations following this investment based on Fund values at 30th September 2020 and total DIP commitments to Property would be as follows:

Property, £ in DIP	£175m
Property, % in DIP	13.4%
Property in DIP, as % of Total Fund	0.7%
LTEY, % Total Fund (target 20%)	15.9%

3 Policy and Resource Implications

Financial: Investment of £100m to be drawn as required. Fee structure in line with market.

Legal: The investment will be subject to satisfactory completion of due diligence, including review and execution of appropriate legal documentation.

Personnel: None.

Procurement: None.

Council Strategic Plan: Strathclyde Pension Fund aligns with the theme of a well governed city.

Equality and Socio-Economic Impacts:

Does the proposal support the Council's Equality Outcomes 2017-22 Equalities issues are addressed in the Fund's responsible investment policy.

What are the potential equality impacts as a result of this report? No specific impact from this proposal.

Please highlight if the policy/proposal will help address The retail development projects undertaken within Fund I have resulted in the creation of employment opportunities

socio economic disadvantage.	and it is anticipated that similar outcomes could result from Fund II.
Sustainability Impacts:	
Environmental:	See section 2.8
Social, including opportunities under Article 20 of the European Public Procurement Directive:	See section 2.8
Economic:	See section 2.8
Privacy and Data Protection impacts:	To be fully provided for in the legal documentation for the proposed investment.

4 Recommendation

The Committee is asked to **APPROVE** an investment of £100m in Clydebuilt II LP by the Direct Investment Portfolio.

Schedule 1

Investment Manager: Ediston

Ediston Properties Ltd. (“Ediston”) is an Edinburgh based property investment, development, and asset management company which was founded in 2004. It is a dedicated property investment manager focused on the UK market and specialising in equity strategies with an intensive asset management approach/skillset designed to maximise asset values. Ediston Investment Services Ltd. Is a subsidiary company which is authorised and regulated by the Financial Conduct Authority.

Ediston has enjoyed considerable success since Fund I was established and now has Assets Under Management ("AUM") of £710m, including a listed Real Estate Investment Trust (or “REIT”) vehicle (c. £280m) plus a variety of other mandates, in addition to development projects with a GDV of c.£510m. Ediston’s asset base consists mainly of joint ventures with asset managers and pension funds and more recently in 2016 the firm launched a housing development team.

The firm was founded by Chief Executive, Danny O’Neill, who has 28 years of real estate experience. Prior to Ediston, Danny was Investment Director at Standard Life Investments where he was responsible for £2bn of UK property assets including the Standard Life Pooled Property Fund, the largest balanced commercial property fund in the UK at the time.

Alastair Dickie, Director, is directly responsible for the Clydebuilt funds and is SPF’s main point of contact. At Ediston he is responsible for securing and delivering investment, development, and asset management opportunities and managing the existing investment portfolio with a focus on the retail warehouse sector. Prior to joining Ediston in 2010, he was a director at Macdonald Estates and before that Scottish & Newcastle.

Rankin Laing, Finance Director, has 20 years’ experience in the property market and is responsible for all aspects of fund administration, accounting, reporting and investment. Rankin joined Ediston in 2007, prior to which he was Deputy Chief executive at Waterfront Edinburgh Ltd and before that at Standard Life Investments he was responsible for the finance team and £6bn of property assets.

The Ediston team has an in-depth knowledge of the Scottish regional property market and have developed a strong network within Scotland for sourcing deals. The Firm's principal directors have combined sector experience of 125 years, employ 9 in-house surveyors and its development team comprise 13 professionals with a combined experience of over 250 years.

Schedule 2

Clydebuilt Fund I

Since its inception, Fund I has acquired a portfolio of 14 commercial property assets comprising 10 income-generating assets (with asset management potential) and 4 development opportunities, with a bias towards the retail (mainly retail parks, rather than high street units) and leisure sectors.

The development assets include 2 major retail park projects at Port Glasgow in Inverclyde and more recently, the Crown Street Retail Park in the New Gorbals area of Glasgow, both of which were developed from undeveloped sites.

Also within the retail part of the Fund I portfolio is the Shawlands Arcade in Glasgow's southside, a more complex, longer term redevelopment project requiring the management of a multitude of existing commercial tenancies prior to the being able to proceed. While this has taken time, reasonable progress has now been made and the first phase of the proposed redevelopment will potentially progress in 2021.

In late 2019, KPMG were commissioned to conduct a formal review of Fund I's progress. The review confirmed that Ediston had succeeded in sourcing assets through a broad network of agents, landlords and advisers. . The fund's value had grown significantly through a combination of investment returns, re-invested income and debt funding. During 2020 however, as a result of the Covid-related downturn, the assets have been subject to a downwards revaluation.

With Fund I approaching the scheduled expiry of its 7-year term in April 2021, Ediston had begun the marketing strategy for each asset, prior to the Covid enforced lockdown, which not surprisingly, has adversely affected progress.

Two of Fund I's portfolio of 14 properties had been sold prior to 2020, while a third sale has recently been completed at the pre-Covid negotiated price. The sale of another property however was aborted at a late stage at the onset of the downturn, while anticipated interest in a number of other assets has fallen away due to market caution. As a result of this, Fund I's term has been extended by 2 years to April 2023, specifically to avoid the enforced sale of assets (or the perception of Fund I being a distressed seller) at sub-optimal prices.

Fund I's remaining portfolio of 11 properties now comprises 5 retail assets (4 retail parks plus a terrace of shops in the West End of Glasgow) representing 65% of the fund's total value, 3 leisure assets (12%), 2 offices (19%) and a single industrial unit (4%).

Intensive asset management has also been required in respect of rent collection and rent deferral requests. Ediston are responding to these pragmatically where possible/justified, whilst negotiating for example, lease extensions or the removal (or introduction) of lease break clauses in return.

Investment Specific Risks

Market Risk

The property market is subject to periodic shifts in economic conditions and the current Covid-related downturn is a good example of this. It is also susceptible to longer term structural changes in corporate and/or consumer behaviours, such as the adverse effects of the increased prevalence of online shopping on both the high street and shopping centre retail sub-sectors in particular. This manifests itself in both long term reduction in asset values as well as the potential demise of individual retailer/tenants who are more exposed to a bricks and mortar market presence than their online competitors.

Ediston have demonstrated that there are still attractive opportunities to be secured even within broader sectors facing headwinds. Their strategy is to seek out undervalued opportunities, where intensive and proactive asset management affords the potential to create/enhance asset values whilst at the same time being mindful of current market trends.

Development / Construction Risk

The Ediston team has extensive experience in the property development process from site identification, the planning process, acquisition and construction.

Where Ediston undertakes developments it will engage strong/reputable national construction contractors on fixed price building contracts (cost over-runs being at the contractor's risk) incorporating performance bonds &/or parent company guarantees as applicable, to ensure there is an appropriate level of financial comfort available in the event of contractor failure. The construction contracts will include provisions for payments to be made in arrears and subject to formal development valuations with financial penalties for delays in completion.

The risk of contractors failing cannot be completely eliminated and in such a scenario Ediston would require to replace the contractors using the performance bonds, guarantees, contract retentions and other measures to cover the extra financial costs.